General Services Administration
Office of General Counsel
Washington, DC 20405

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September 11, 1992

Ms. Donna Searcy, Secretary
Federal Communications Commission
1919 M Street, N.W. - Room 222
Washington, D.C. 20554

Re: Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes CC Docket No. 92-133

Dear Ms. Searcy:

Enclosed please find the original and nine copies of the Comments of the General Services Administration for filing in the above-referenced docket.

Sincerely,

Michael J. Ettner

Michael J. Ettner
Senior Assistant General Counsel
Personal Property Division

Enclosures

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FEDERAL COMMUNICATIONS COMMISSION
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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes	)	CC Docket No. 92-133

COMMENTS OF THE GENERAL SERVICES ADMINISTRATION

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September 11, 1992

COMMENTS OF THE GENERAL SERVICE ADMINISTRATION

CC DOCKET NO. 92-133

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SUMMARY

The cost of capital has fallen sharply since the adoption of the existing authorized rate of return for LECs. The Commission should promptly reform its procedures and initiate a new proceeding to determine the appropriate rate of return under current market conditions.

This new return should not only be adopted as the new target for rate of return LECs, it should also be used to adjust the sharing parameters of the LEC price cap plan. All LECs should be required to reflect the newly authorized rate of return in their April, 1993 access filings.

GSA recommends an automatic trigger mechanism which would be consulted each September. If the trigger is reached, it would initiate a new represcription proceeding targeted for the following July access charge filing. Specifically, GSA recommends that a change of 1.5 percent in 10-year Treasury Bond yields should trigger a new proceeding. Since this condition has already been met, GSA urges the Commission to move expeditiously to represcribe the LECs' rate of return..

GSA agrees with the Commission's proposal that a notice and comment procedure should replace the current, overly complex "paper hearing" process. Comment and reply filings would be augmented by basic data filings specified by the Common Carrier Bureau and the automatic filing of studies, financial analyst reports and other documents relied upon by the parties' experts in preparing their presentations. Although the Commission may choose to specify those data and procedures to which it will

accord the most weight, it should not restrict the arguments of any party.

The Commission should also change its enforcement rules for rate of return LECs to be consistent with the sharing mechanisms it has established for price cap LECs.

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COMMENTS OF THE GENERAL SERVICES ADMINISTRATION

The General Services Administration ("GSA"), on behalf of the Federal Executive Agencies, hereby submits its Comments in response to the Commission's Notice of Proposed Rulemaking and Order ("NPRM"), FCC 92-256, released July 14, 1992 in CC Docket No. 92-133. This order solicited comments on the Commission's proposals for fundamental reform of its rate of return represcription and enforcement processes.

I. INTRODUCTION

The need for fundamental reform of the Commission's rate of return represcription and enforcement processes is dramatized by the fact that the Commission seems to be avoiding a lowering of the local exchange carrier ("LEC") authorized rate of return despite a dramatic drop in the cost of capital.

GSA comments support reforms which will make the Commission's rules more responsive to changes in the cost of capital and more equitable to all concerned parties. At the same time, such reforms should result in less burden to both the industry and the Commission.

Application of the rules will demonstrate that the Commission should immediately commence a new represcription proceeding. This new proceeding can and should be conducted to ensure that the sharing zones for price cap LECs and the rates for rate of return LECs are appropriately established by July 1, 1993.

II. PRICE CAP SHARING LIMITS SHOULD BE ADJUSTED WHENEVER THE AUTHORIZED ROR IS REPRESCRIBED.

The NPRM states that "[a]lthough any future represcription would not affect the sharing zones for price cap LECs, it would change their universal service fund distributions and long term support contributions."[1] GSA believes that this statement is not only erroneous, it is also the basis for the Commission's ill-advised deferral of the long-overdue 1992 represcription proceeding.

The only possible support for this statement is the following paragraph from the Commission's 1990 LEC price cap order:

> 129. In order to provide a reasonable period in which to review the operation of the price cap plan, we anticipate continuing the earnings levels in the

[1] NPRM, footnote 92.

> backstop at the levels adopted here, for at least the initial four-year price cap period, absent a compelling reason to adjust them.[2]

There is no record to support this "anticipation" on the part of the Commission, since the continuation of backstop earnings levels was neither proposed by the Commission nor discussed by commenters at any stage of the proceeding.[3]

There was, however, a full record developed on the need to link the backstop sharing mechanism to the authorized rate of return. The Commission drew upon this record extensively in the LEC Price Cap Order, stating, for example:

> In the Supplemental Notice we proposed a 200 basis point or 2 percent no sharing zone *above the authorized rate of return*.[4]
>
> ***
>
> The mechanisms we adopt here ensure that ratepayers share further in the benefits a price cap system can produce. If a LEC whose rates are at or below the price cap can outperform the 3.3 percent productivity offset embedded in the price cap, thereby earning a higher profit, the LEC will be entitled to retain all of its earnings up to 100 basis points (or

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[2] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313 Second Report and Order, 5 FCC Rcd 6786 (1990) and Erratum, 5 FCC Rcd 7664 (1990) ("LEC Price Cap Order"), para. 129.

[3] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Notice of Proposed Rulemaking, 2 FCC Rcd 5208 (1987) ("Notice"); Further Notice of Proposed Rulemaking, CC Docket No. 87-313, 3 FCC Rcd 3195 (1988) ("Further Notice"); Report and Order and Second Further Notice of Proposed Rulemaking, CC Docket No. 87-313, 4 FCC Rcd 2873 (1989) ("AT&T Price Cap Order"); Supplemental Notice of Proposed Rulemaking, CC Docket No. 87-313, 5 FCC Rcd at 2176 (1990) ("Supplemental Notice"). See also FCC Public Notice, Parties in Price Cap Proceeding Requested to File Draft Rules Implementing Proposed Price Cap Plans, 3 FCC Rcd 262 (Com.Car.Bur. 1988).

[4] LEC Price Cap Order, para. 163 (emphasis added).

1 percent) *above the 11.25 percent unitary rate of return established for rate of return carriers.*[5]

***

Based on the 11.25 percent rate of return we select in the companion item we adopt today, this mechanism allows LECs whose performance exceeds the 3.3 percent productivity offset to potentially earn up to an effective equivalent of a maximum 14.25 percent rate of return.[6]

***

The third component of the plan is a zone wherein LECs are required to return 100 percent of their earnings in the form of lower rates to the extent earnings exceed 5 percentage points above the rate of return. *Based on the 11.25 percent rate of return we adopt today* in the companion Represcription Order, this zone begins at 16.25 percent.[7]

***

We have determined that the no sharing zone should extend to 12.25 percent. If we set the formula adjustment mark symmetrically [*with respect to the authorized rate of return*], it will be 10.25 percent.[8]

The sharing zone and formula adjustment mark were thus inextricably linked to the authorized rate of return. The achievement of just and reasonable rates, indeed the very legality of the LEC price cap plan, depends upon the maintenance of this linkage. This relationship is most vividly demonstrated by considering the hypothetical condition that would exist if the cost of capital had increased. Under that condition the authorized return should be raised, and the formula adjustment mark and the sharing zone would have to be raised. If they were not raised, the LECs would be denied a rate increase despite

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[5] Id., para. 7 (emphasis added).

[6] Id., para. 7 (emphasis added).

[7] Id., para. 125 (emphasis added).

[8] Id., para. 165 (emphasis added).

possibly confiscatory rates. Even more bizarre would be the forced sharing of earnings with ratepayers when those earnings were *below* the newly authorized rate of return. Certainly the LECs would not remain silent in the face of such a development. The Commission would be awash in emergency petitions and court actions.

The current situation is equally as unjust but in the opposite direction. It is ratepayers, rather than LECs, who are injured. The cost of capital has fallen sharply and, as GSA will demonstrate, the authorized return should be lowered. Unless the lower adjustment mark and sharing zones are also adjusted, the LECs will receive a continuing revenue windfall at ratepayers expense. LECs could find themselves eligible for price increases even though their earnings are already well above the authorized rate of return. Ratepayers would be deprived of sharing even though LEC earnings far exceed 100 basis points above the authorized return. The Commission must protect the public interest and not allow such a condition to develop.

GSA believes the Commission did not originally intend the LEC price cap plan to result in inappropriately high or low rates during its trial period. GSA interprets Paragraph 129 of the NPRM as intending that the symmetrical zone around the authorized return would remain 100 basis points for the duration of the trial period. Or the Commission may have expected the reader to understand that a change in the authorized rate of return would in itself be a "compelling reason to adjust" the backstop. In any case, the Commission must make it clear now that a change in the authorized rate of return will automatically result in a parallel change to the sharing zone and formula adjustment mark.

III. CHANGES IN THE COST OF CAPITAL SHOULD BE EXAMINED ANNUALLY AND REPRESCRIPTION PROCEEDINGS SHOULD BE SHOULD BE INITIATED IF SIGNIFICANT CHANGE HAS OCCURRED.

GSA agrees with the Commission that the current biennial schedule for rate of return proceedings should be replaced with a trigger based on changes in the capital markets.[9] GSA believes, moreover, that the trigger should be automatic.

The Commission itself admits that the current "...practice has been to defer represcription proceedings to devote administrative resources to more pressing matters."[10] GSA submits that as long as the LECs retain virtual monopoly control over access, there is no "more pressing matter" than the maintenance of an appropriate rate of return as a benchmark for the sharing limits of price cap LECs. Price cap LECs have a combined rate base of about $30 billion, and one percent in return thus represents ratepayer revenues of $450 million.[11] Although GSA fully supports the Commission's efforts to

9 NPRM, Para. 19

10 NPRM, para. 20

11 One percent of $30 billion is $300 million in earnings. $450 million in revenues are required to generate $300 million in earnings.

encourage competition in the provision of local access, until effective competition is realized, the Commission must fulfill its role as a regulator. Prescribing and enforcing a rate of return may be "old fashioned", but it remains the keystone of just and reasonable rates. The Commission can and should continue its efforts to bring incentives to the interstate access market, but it must not in the process abandon its traditional role as the protector of the consumer's interest in fair and reasonable rates.

GSA does not believe that the routine examination of a trigger mechanism need be burdensome on either the industry or the Commission. Indeed, this examination should be keyed to the annual access filing schedule. GSA proposes that each September the Commission examine the trigger it has chosen and automatically initiate a rate of return proceeding if the trigger point is reached. As GSA will explain, this proceeding can be concluded in sufficient time for its results to be incorporated into the following April's access tariff filings.

Considerable resources have been used in past years in first deciding if a proceeding should be initiated and then determining a rate of return. Since both decisions hinge on whether the cost of capital has changed, much of this effort has been duplicative. The establishment of an automatic trigger should actually reduce the burden on all parties in the long run.

IV. A CHANGE OF 1.5 PERCENT IN THE 10 YEAR TREASURY BOND YIELD SHOULD TRIGGER A RATE OF RETURN PROCEEDING.

The automatic trigger mechanism should be simple to use and to understand, responsive to changes in the capital market and based upon publicly available, reliable data. Such a trigger will cause the initiation of a proceeding when, and only when, a significant change has occurred in the capital markets since the last prescription.

GSA has considered a number of such triggers, and concluded that the 10 year United States Treasury security yield, as prepared monthly for the Joint Economic Committee by the Council of Economic Advisors, would be most suitable.[12] The key determination in any rate of return proceeding is the appropriate return on equity, and the use of intermediate term Treasury Bond interest rates would tend to reflect fundamental changes in equity returns better than either short or long term bond yields, while avoiding the complexities involved in the compilation and analysis of stock market data.

In Attachment 1, GSA compares the annual yield of 10 year Treasury Bonds ("T-Bonds") to the return on equity prescribed by the Commission over the last quarter century. Although the Commission's prescriptions have generally tracked T-Bond yields, at times there has been a considerable lag between adjustments. As a result, the implied risk premium has been as low as .5

12 Economic Indicators, United States Government Printing Office.

percent in 1980, when the cost of capital was increasing, and as high as 6.8 percent in 1985, when the cost of capital was going down.[13] Such variations are both unnecessary and unfair to the LECs and their customers.

In Attachment 2, GSA has modeled its proposal under the assumption that a 1.5 percent change in T-Bond yields would have triggered a represcription proceeding which resulted in a change in the cost of equity prescription. The GSA model assumes that the return on equity was changed in each year in which the T-Bond yield varied by 1.5 percent from its level at the time of the last prescription. In these years, the model sets the return on equity at a level corresponding to the average risk premium implied over the last 25 years, 4.3 percent.[14]

Had GSA's proposal been in effect, there would have been six instead of five represcriptions since 1967. As shown on Attachment 2, the derived return on equity would have tracked the cost of capital more closely. As the cost of capital went up sharply, there would have been represcriptions in 1979, 1980, and 1981 instead of just in 1981. As the cost of capital went down sharply, there would have been represcriptions in 1983 and 1986 instead of 1986 and 1990. The average risk premium would have been almost identical to the historical average,[15] but the minimum would have been 2.9 percent and the maximum only 5.6 percent. Clearly the deleterious effects of regulatory lag

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13 See Attachment 3.

14 Id.

15 Id.

would have been reduced to the benefit of both LECs and their customers.

In practice, the application of the trigger would be simple. The Commission would examine the T-Bond yield for August of each year, and would initiate a proceeding if it varied by 1.5 percent from the yield at the time of the last prescription. When the proceeding concludes in March of the following year, the new trigger could be established as the T-Bond yield for February.

The Commission should apply these rules immediately. The current rate of return prescription has been in effect since 1990 when the T-Bond yield was 8.6 percent.[16] The July 1992 T-Bond yield was only 6.8 percent,[17] a drop of 1.8 percentage points. This trend has continued in August, with T-Bond yields falling below 6.5 percent.[18] Clearly, it is time to initiate a new rate of return proceeding.

The Commission's deferral of the next represcription proceeding in the NPRM should be reversed.[19] The Commission should now make good on its pledge to "revisit this deferral if changes in the capital markets indicate that a represcription proceeding is warranted."[20]

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16 NPRM, Exhibit C

17 Economic Indicators, July 1992, p. 30.

18 Wall Street Journal, August 13, 1992.

19 NPRM, para. 103.

20 Id.

V. REPRESCRIPTION PROCEEDINGS SHOULD BE CONDUCTED AS NOTICE AND COMMENT PROCEEDINGS.

GSA agrees with the Commission that the current represcription system "goes far beyond what is necessary to achieve the goals of our represcription proceedings".[21] Notice and comment procedures are used effectively by the Commission for most other issues, and they should be used for rate of return proceedings as well.

Once a proceeding is initiated, however, the Commission should not attempt to restrict the arguments presented by the parties. It is quite appropriate, of course, for the Commission to specify the weight it accords to various types of data and procedures, but it need not and should not limit the evidence it will hear.

The Commission makes two proposals to supplement the normal comment and reply process, however, which should be adopted. First, it proposes to continue to allow the Bureau "to require participants to submit data or studies that are reasonably calculated to lead to the development of a full and fair record...."[22] Since GSA firmly believes that changes in the authorized return should automatically change the price cap sharing limits, it would be appropriate to continue to require either the Regional Holding Companies ("RHCs") or their representatives to provide certain basic data at the outset of each proceeding. Such data could include:

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21 NPRM, para. 27.

22 NPRM, para. 11.

1. RHC Discounted Cash Flow ("DCF") calculations using Institutional Brokers Estimate System ("IBES") growth estimates.
2. Standard & Poor 400 DCF calculations by quartile.
3. Utility and Treasury Bond yields.
4. Recent State Commission rate of return findings.

The centralized filing of such basic data would eliminate redundant showings and considerably lessen the burden of participating in proceedings for all parties.

The second proposal made by the Commission is to require automatic disclosure of "...studies, financial analyst's reports and other documents the parties' experts relied upon in preparing their presentations".[23] Although the filing of such documents would increase the bulk of initial presentations, it would reduce the time and resources required for discovery procedures.

In summary, then, a rate of return proceeding would be initiated by the Commission in September of each year in which the trigger indicates a significant shift in the cost of capital. The remainder of the schedule would be as follows:

October -	RHCs file basic data.
December -	All parties file comments.
February -	All parties file replies.

23 NPRM, para. 34.

March -	Commission issues order.
April -	LECs file access charges reflecting order.
July -	New rates go into effect.

Since reply comments in this proceeding are not scheduled until October 13, it will be incumbent upon the Commission to conclude this proceeding promptly and, as GSA has recommended, simultaneously initiate a new rate of return represcription proceeding.

VI. EXCESS EARNINGS BY ROR CARRIERS SHOULD BE SUBJECT TO THE SAME SHARING RULES AS PRICE CAP CARRIERS.

The Commission also raises the question of enforcement of its prescriptions for rate of return LECs. GSA believes that the sharing rules developed after extensive study for the price cap LECs should also be adopted for rate of return LECs. Incentive regulation is as appropriate for small LECs as for large ones, and and the carefully crafted sharing rules will provide both incentives for the rate of return LECs and appropriate safeguards for their customers. There is no need for the Commission to "reinvent the wheel" on this issue.

VIII. <u>CONCLUSION</u>

As the agency vested with the responsibility for acquiring telecommunications services for use of the Federal Executive Agencies, GSA fully supports the Commission's efforts to introduce competition into the provision of interstate access. Until effective competition is realized, however, it is critical that the Commission maintain an authorized rate of return reflective of current capital markets. In this manner, the Commission will protect the consumer's interest in fair and reasonable rates. To this end, GSA strongly recommends that the Commission adopt the reforms discussed above and immediately commence a new rate of return proceeding.

Respectfully submitted,

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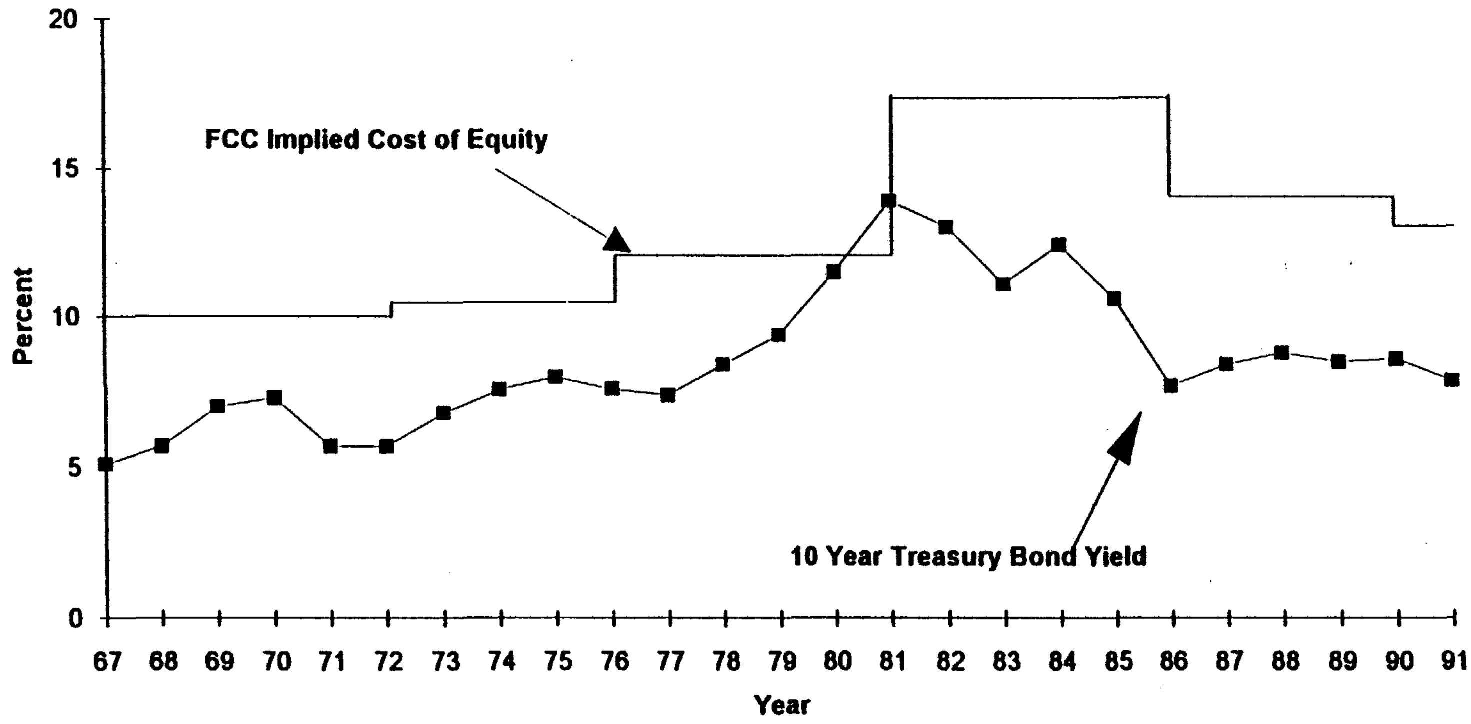
September 11, 1992

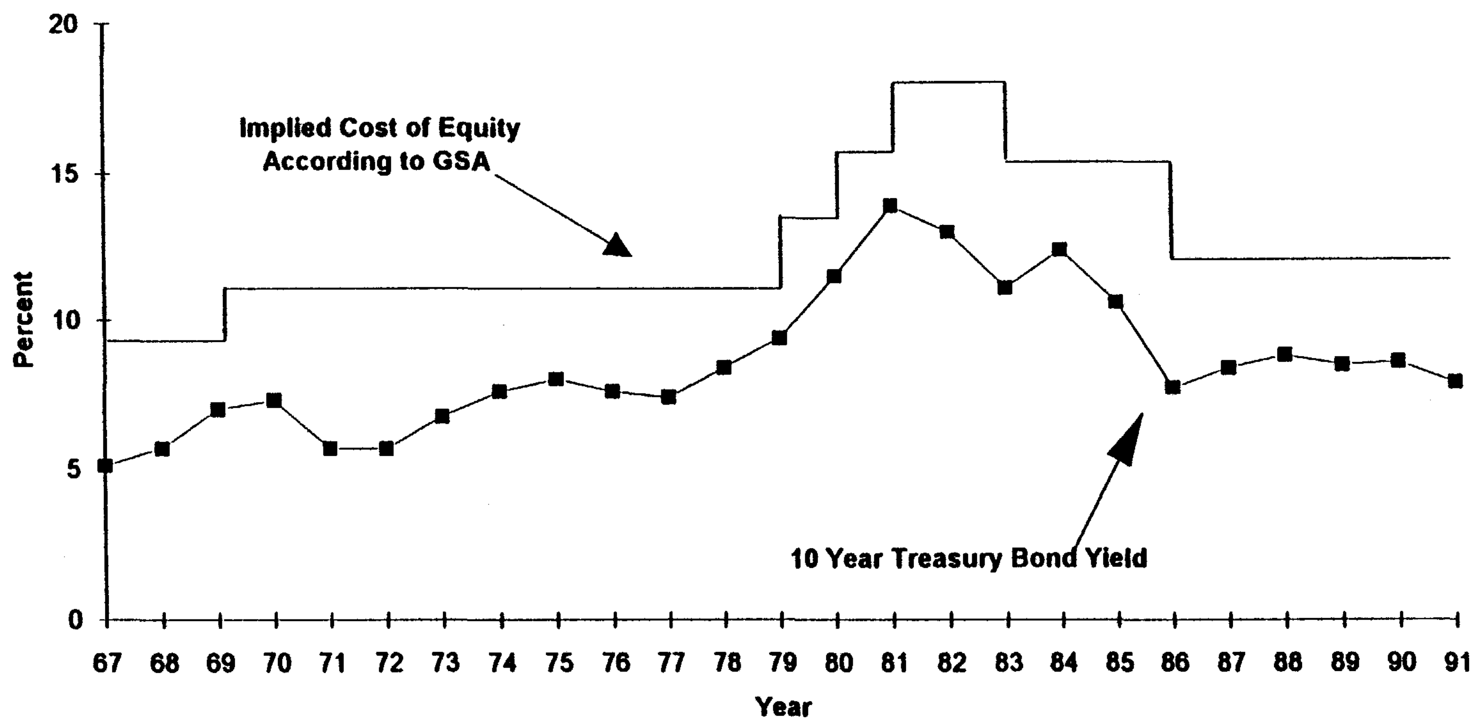
ATTACHMENT 1

Comparsion of 10 Year Treasury Bond Yield To FCC Implied Cost of Equity , 1967 to 1991



Source: Attachment 3

Comparsion of 10 Year Treasury Bond Yield To Implied Cost of Equity According to GSA Proposal, 1967 to 1991



Source: Attachment 3

ATTACHMENT 2

IMPLIED RISK PREMIUMS

YEAR	10 YR T BONDS (A)	FCC ROE (B)	RISK PREMIUM (C)	PROP ROE (D)	RISK PREMIUM (E)
67	5.1	10.0	4.9	9.4	4.3
68	5.7	10.0	4.3	9.4	3.7
69	7.0	10.0	3.0	11.3	4.3
70	7.3	10.0	2.7	11.3	4.0
71	5.7	10.0	4.3	11.3	5.6
72	5.7	10.5	4.8	11.3	5.6
73	6.8	10.5	3.7	11.3	4.5
74	7.6	10.5	2.9	11.3	3.7
75	8.0	10.5	2.5	11.3	3.3
76	7.6	12.0	4.4	11.3	3.7
77	7.4	12.0	4.6	11.3	3.9
78	8.4	12.0	3.6	11.3	2.9
79	9.4	12.0	2.6	13.7	4.3
80	11.5	12.0	0.5	15.8	4.3
81	13.9	17.4	3.5	18.2	4.3
82	13.0	17.4	4.4	18.2	5.2
83	11.1	17.4	6.3	15.4	4.3
84	12.4	17.4	5.0	15.4	3.0
85	10.6	17.4	6.8	15.4	4.8
86	7.7	14.2	6.5	12.0	4.3
87	8.4	14.2	5.8	12.0	3.6
88	8.8	14.2	5.4	12.0	3.2
89	8.5	14.2	5.7	12.0	3.5
90	8.6	13.2	4.6	12.0	3.4
91	7.9	13.2	5.3	12.0	4.1
AVG.			4.3		4.1

Sources:

Column A - Economic Report of the President, February 1992, Table B-69
Column B - NPRM, Exhibit C
Column C - Column B minus Column A
Column D - GSA Proposal
Column E - Column D minus Column A

CERTIFICATE OF SERVICE

I, MICHAEL J. ETTNER, do hereby certify that copies of the foregoing "Comments of the General Services Administration" were served this 11th day of September, 1992, by postage paid or hand delivery (indicated below by asterisks) to the following parties:

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